

Public finances in Portugal: a brief long-run view^{*}

António Afonso^{\$ #}

January 2007

Abstract

This paper provides a succinct overview of long-run developments regarding public finances in Portugal with an emphasis on the spending side. Issues addressed are the excessive deficit experiences of Portugal, the past experience with fiscal consolidations, and labour cost competitiveness. It is fair to say that public spending control has been a problem in Portugal, and fiscal consolidations in the 1980s and 1990s have been short-termed and mostly not successful. Additionally, the compensation of general government employees diverged vis-à-vis the EU15 after EU entry.

JEL: E62, E65, H6

Keywords: public finances, Portugal, fiscal consolidations, compensation of employees

^{*} I am grateful to Manuela Arcanjo, Vítor Gaspar, and participants at the seminar of the 25 years of CISEP (Lisbon, December 2006) for helpful comments. The opinions expressed herein are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

^{\$} CISEP – Research Centre on the Portuguese Economy; UECE – Research Unit on Complexity and Economics; Department of Economics, ISEG/TULisbon – Technical University of Lisbon, R. Miguel Lupi 20, 1249-078 Lisbon, Portugal, email: aafonso@iseg.utl.pt.

[#] European Central Bank, Directorate General Economics, Kaiserstraße 29, D-60311 Frankfurt am Main, Germany, email: antonio.afonso@ecb.int.

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1. Introduction

This paper provides a succinct overview of long-run developments regarding public finances in Portugal, with a particular emphasis on the expenditure side. As regularly mentioned by international organisations, in the last twenty years or so public spending control has been a problem in Portugal, with significant increases in primary spending. For instance, the gains obtained from the drop in interest rates and the reduction in the interest payments on the outstanding government debt were mostly used to increase public spending, and not seen as a window of opportunity to consolidate public finances. Indeed, given past performance and outcomes, it seems fair to say that after entering the European Union (EU) in 1986, joining the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1992 and adhering to the European and Monetary Union (EMU) on January 1999, Portugal's track record in implementing fiscal policy could have been better.

The fiscal consolidations that occurred in the 1980s and in the 1990s have been short-termed and mostly not successful. Portugal was the first country in the EU to breach the Stability and Growth Pact (SGP) in 2002, becoming therefore subject to the Excessive Deficit Procedure (EDP), a situation that occurred again in 2005. So far, capital markets have given the benefit of the doubt to Portugal, allowing both for mostly stable sovereign debt ratings and for low long-term government bond interest rates, with limited spreads vis-à-vis the German benchmark. However, this may change in the future in the continued absence of good fiscal performance.

Additionally, the compensation of employees in the general government, a relevant spending item, notably in terms of demonstration effect for the private sector, diverged vis-à-vis the EU15 average after 1987-88, as a share of GDP. Moreover, unit labour costs also exhibited a higher growth than in the case of Portugal's main trading partners. These factors, coupled with high external imbalances in the last years, may have impinged negatively on Portugal's competitiveness.

The organisation on the remainder of the paper is as follows. Section two offers some considerations on the role of public finances in promoting growth. Section three reviews developments in public finances in Portugal such as past trends, excessive deficits, the capital markets assessment of fiscal outcomes, and episodes of fiscal consolidations. Section four addresses developments of general government labour costs. Finally, section five presents some concluding remarks.

2. Public finances quality and growth

Public expenditure composition is increasingly the focus of policy debate in the EU while international institutions and governments realise that they need to assess expenditure performance and efficiency. At the EU level the Working Group for the Quality of Public Finances within the Economic Policy Committee carries out such related work and analysis. Moreover, the European Commission argues for assessing the fiscal policy stance in the Member States also taking into account the quality of spending and of fiscal adjustments. Such analysis may also be present when assessing the countries' Stability Programmes, notably in terms of public spending redirecting measures.

Expenditure policies support growth and sustainability if they provide a supportive environment for a functioning market economy; limit commitments to so-called core and/or productive spending and to basic safety nets; provide services in an efficient manner; and maintain sustainable deficits and debt, allowing automatic stabilisers to operate.¹ Figure 1 illustrates a possible set of linkages between public finances and growth, emphasising public spending composition and efficient outcomes as a relevant determinant of economic growth.

Naturally, several problems arise when trying to assess core spending and “high quality” of public finances. For instance, even if core spending is needed in such areas as education, health, redistribution and infrastructure, this is a hard concept to define. On the other hand, even if redistribution may reduce incentives to work, it may also promote

¹ On the relevance of public expenditure reform see for instance, ECB (2006).

growth, by diminishing the need for high savings and fostering consumption. Additionally, international comparability of results is scarce and a demanding exercise.²

Figure 1 – Public finances and economic growth

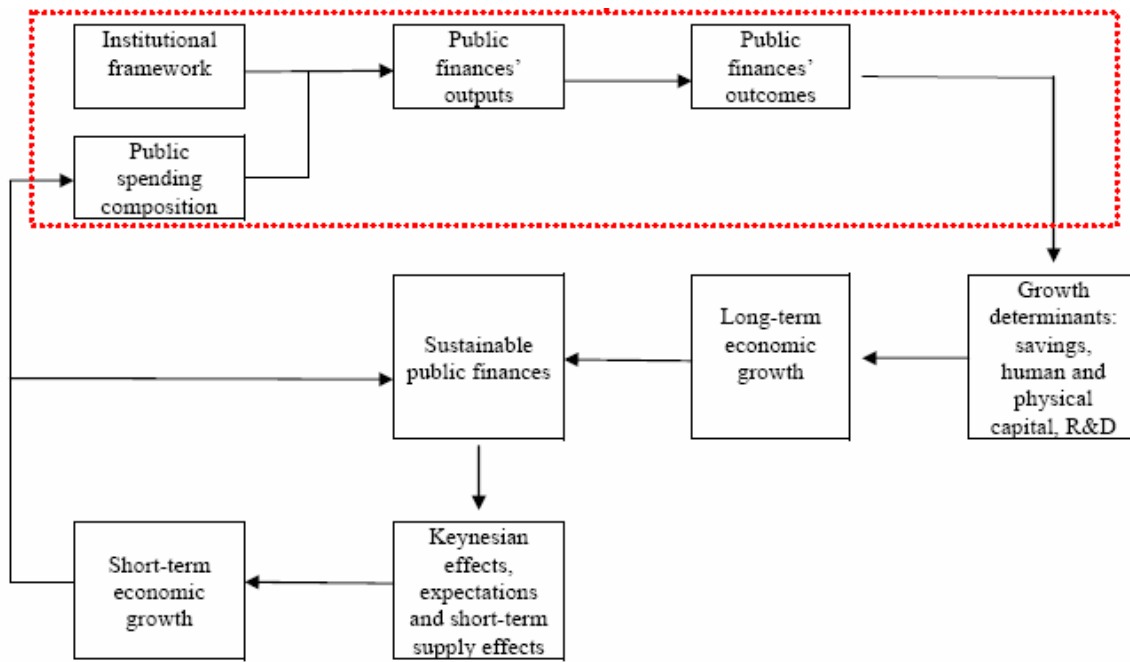


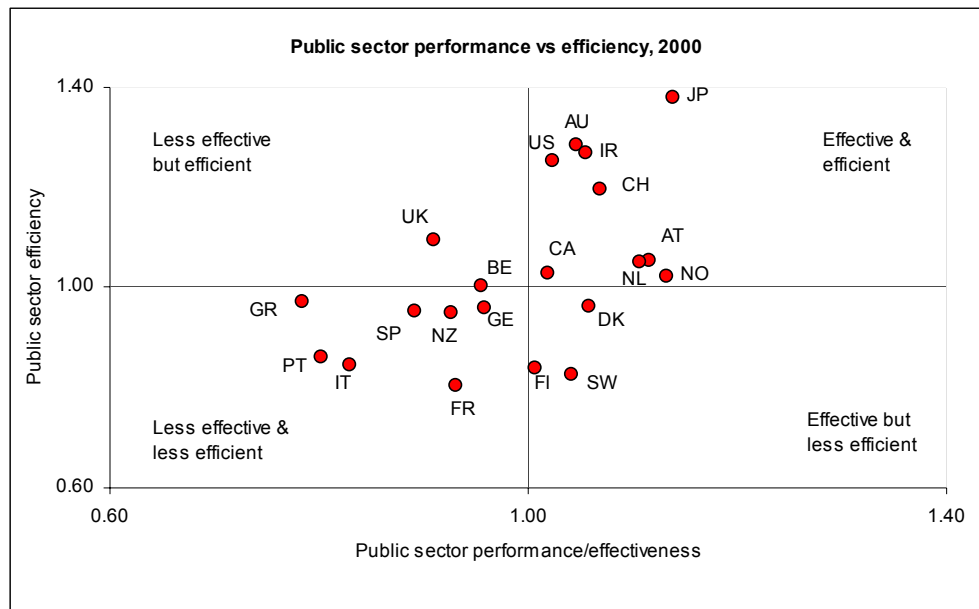
Figure 2 shows the positioning of OECD countries in terms of the pair performance and efficiency of public sector outcomes. In this context, Portugal's situation clearly suggests that there is some room for improvement, both in terms of public spending performance and efficiency. Indeed, according to the reported results, Portugal is located in the diagram in the lower left-hand side quadrant (together with Italy, Greece, France and Spain), implying that other countries are both more effective in producing public sector outputs and that they are also more efficient in performing such tasks.

Interestingly, one can also observe the existence of good performing countries (in the two right-hand side quadrants) both with lower (Finland, Sweden, and Denmark) and higher (Austria, Japan, Ireland, US) efficiency levels. Overall, one can conclude that similar and above average public outcomes may be attained with different amounts of resources

² Available evidence on public spending efficiency, provided by Afonso et al (2005) and Afonso and St. Aubyn (2006), report that significant inefficiencies are present in several countries, Portugal included.

engaged in public spending activities, and this has to be seen as a country-specific policy decision.

Figure 2 – Spending performance and efficiency



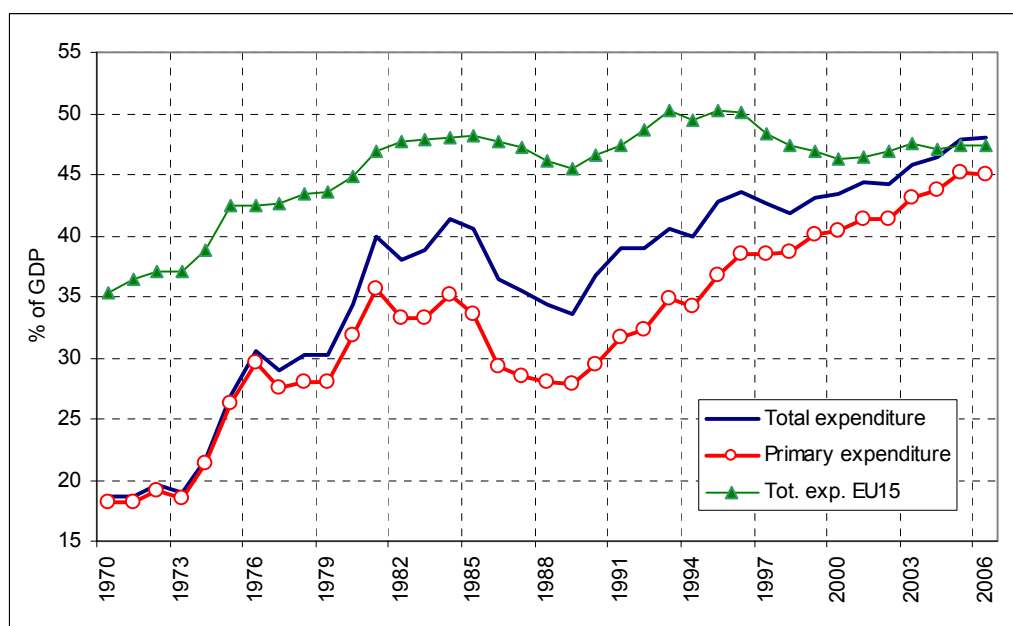
Source: adapted from Afonso, Schuknecht and Tanzi (2005).

3. Developments in public finances

3.1. Past trends

Public expenditure in Portugal has been a challenge for fiscal control and overall competitiveness. Past expenditure trends have not been reassuring as can be seen from Figure 3, with primary expenditure averaging 23.5, 31.6, and 35.5 per cent of GDP respectively in the 1970s, 1980s, and 1990s, and reaching an average of 42.9 per cent between 2000 and 2006. Naturally, this development tracked, to some extent, the upward trend in public spending in the EU15 countries in the past three decades, where a significant increase in the total expenditure-to-GDP ratio also occurred from 1970 until the beginning of the 1990s, from 35.4 per cent of GDP in 1970 to around 50 per cent of GDP in 1993-1995. Thereafter, the total expenditure ratio declined in the EU15 but continued to increase in Portugal.

Figure 3 – Public spending-to-GDP ratios, Portugal and EU15 (1970-2006)

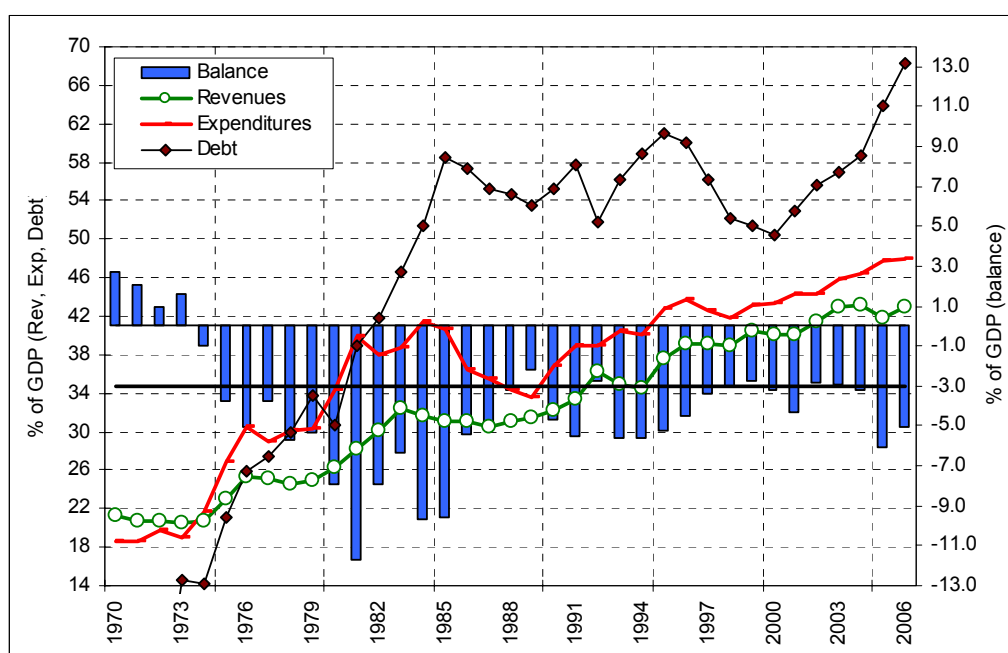


Source: European Commission.

The limitations imposed by the need to ensure sound public finances, notably in order to meet the Maastricht fiscal criteria, led most EU countries to curb down public expenditure behaviour from the mid-1990s onwards. The expenditure-to-GDP ratio in the EU15 was reduced from 50.3 per cent in 1995 to 46.2 per cent in 2000, halting therefore the raising trend of public expenditures in the EU. More particularly, the ratio of total public expenditure-to-GDP declined between 1995 and 2000 for all EU countries, with the exception of Greece and Portugal. Shortly after, Portugal was faced with a budget deficit above 3 per cent of GDP in 2001 (see Figure 4).

Another conclusion to be drawn from Figure 4 is that in the twenty-one years that passed after Portugal's adhesion to the EU in 1986, only in six years was the general government budget deficit below 3 per cent of GDP, averaging around 4 per cent in the entire period. In other words, relevant fiscal imbalances were recorded in more than two thirds of the period of Portugal's EU membership.

Figure 4 – Budget balance and debt-to-GDP ratios in Portugal (1970-2006)



Source: European Commission.

As a result of an upward trend in public spending and persistent budget deficits, the debt-to-GDP ratio increased during the 1970-2006 period, with a temporary reversion in the second half of the 1990s.³ The debt ratio averaged 23.8, 48.9, and 56.0 per cent of GDP respectively in the 1970s, 1980s, and 1990s, reaching an average of 58.1 per cent between 2000 and 2006. Quite telling of a lack of a strong commitment to fiscal consolidation efforts in Portugal is the fact that even though the debt ratio declined 10.7 percentage points (pp) of GDP between 1995 and 2000, notably due to strong growth (real GDP growth rate averaged 4.1 per cent in that period), and dropping interest rates, the total expenditure ratio did not decline in a sustainable way.⁴

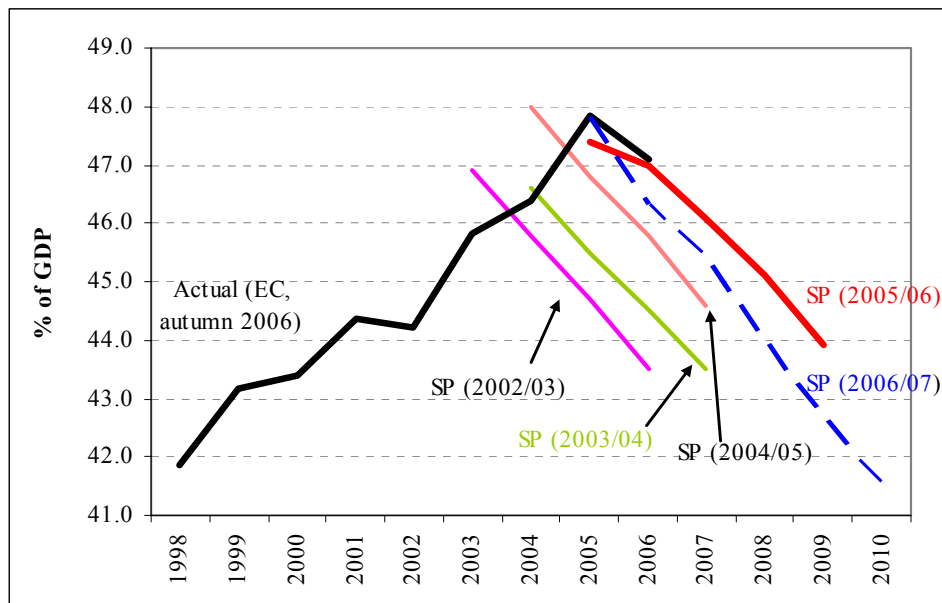
Another point worthwhile mentioning, and which can be confirmed with Figure 5, is that the actual outcomes of public finances, notably on the spending side, have generally turned out worse than initially foreseen. Put in another way, official forecasts have been

³ One should notice that it was in the period 1996-1998 that substantial privatisation revenues were obtained, with the amounts channelled to debt redemption adding up to 6.2 per cent of GDP in those three years.

⁴ In this context Constâncio (2005) argues “Portugal misused fiscal policy twice in the decade” (the 1990s).

mostly on the optimistic side. For instance, the 2002 Stability Programme reported for 2005 an expected spending-to-GDP ratio 3 percentage points below the actual outcome. This systematic underestimation of spending also seemed to be a common feature of the subsequent updates of the Portuguese Stability Programmes (even if not an isolated case in the EU).

Figure 5 – Public spending-to-GDP ratio in the Stability Programmes



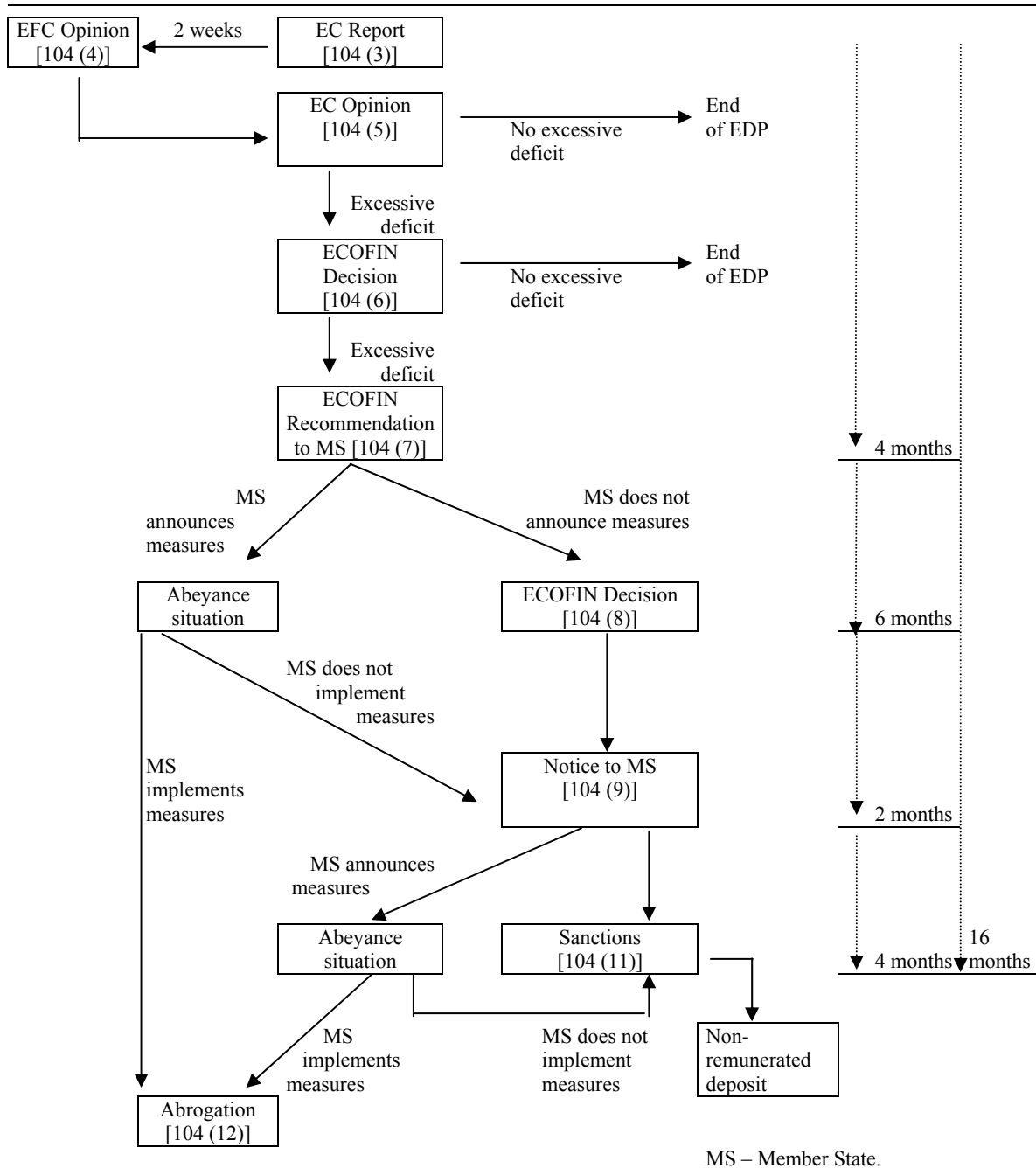
Source: European Commission and Stability Programmes.

3.2. Excessive deficits

This subsection provides a brief factual stocktaking of the two EDP experiences faced by Portugal. As already mentioned above, Portugal was the first country in the EU to breach the SGP in 2001, becoming subject to the EDP in 2002, a situation that occurred again in 2005. After the first EDP for Portugal, both Germany and France also breached the 3 per cent limit for the budget deficit in 2002, and become subject to an identical procedure respectively in 2002 and in 2003. Figure 6 offers a graphical representation that summarises the successive steps of the EDP, commonly considered as the corrective arm of the SGP.⁵

⁵ The Stability and Growth Pact consists of a Resolution of the European Council of 17 June 1997, published on 2 August 1997, and of two Regulations of the European Council, N.º 1466/97 and N.º

Figure 6 – Excessive Deficit Procedure



Source: Adapted from Pereira, P.; Afonso, A.; Arcanjo, M. and Santos, J. (2007).

1467/97, both from 7 July 1997, published on 2 August 1997, modified by Regulations N.º 1055/2005 and N.º 1056/2005 of 27 June 2005. See the EC site for additional relevant information on this topic:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm.

The first EDP for Portugal was launched in 2002, the year of the identification of the excessive deficit. On 5 November 2002, the Council decided that an excessive deficit existed in Portugal and issued a recommendation requesting Portugal to bring this situation to an end by 2003 at the latest. Portugal then opted to address the excessive deficit situation still in 2002 (one-off measures amounting to 1.4 per cent of GDP were used in that year), therefore avoiding further steps in the procedure. Subsequently the Council Decision of 11 May 2004 proposed the abrogation of the decision on the existence of an excessive deficit in Portugal in accordance to Article 104(12), stating that the correction of the excessive deficit was completed in 2003.

In 2003 and 2004 Portugal used again sizable temporary measures, amounting respectively to 2.5 and 2.3 per cent of GDP, in order to keep the budget deficit below the 3 per cent limit. Among the temporary measures implemented in the 2002-2004 period, adding up to 6.2 per cent of GDP, one can recall the more relevant ones:

- i) In 2004, the transfers from public sector enterprises to CGA (civil servants pension system) as counterpart for the assumption by the general government of future pension liabilities of the employees of those enterprises;⁶
- ii) In 2003, the securitization of tax credits, which were sold to a resident non-monetary financial institution (comprising taxes and social contributions concerning the period 1 January 1993 to 30 September 2003);
- iii) In 2003, transfers from CTT (Portuguese postal operator) to CGA and to the Treasury, in exchange of the future payment of pensions;
- iv) In 2002, the extraordinary settlement of tax arrears programme (a tax amnesty), the sale of the fixed telecommunications network, and the sale of rights to reintroduce tolls in a highway.⁷

⁶ Transfers were made from the following state-owned enterprises: Caixa Geral de Depósitos, Navegação Aérea de Portugal, Aeroportos de Portugal, and Imprensa Nacional Casa da Moeda.

⁷ Portugal was not alone in the EU regarding the use of temporary measures, which were also used in Belgium (transfers in 2003 from Belgacom to the general government in exchange for future payment of pensions), in Italy (securitization operation in 2002). Additionally, the regularization of tax debts was also implemented in several other countries: Ireland in 2002, Greece in 2002 and 2003, and Italy in 2003.

The adoption of such strategy, making use of temporary measures, even if it prevented the budget deficit from going above the 3 per cent limit, did not address the structural factors behind the underlying Portuguese fiscal imbalances. Additionally, after the 2002 EDP, the consolidation strategy also included an increase in the standard VAT rate (from 17 to 19 per cent, which was again raised to 21 per cent in July 2005), while primary spending continued rising.⁸

The second EDP was initiated against Portugal in 2005 via a Council Decision of 20 September 2005, in line with article 104(6). The deadline of 2008 was given for Portugal to correct the situation. Additionally, the Commission recommended to Portugal a reduction of the cyclically-adjusted deficit, excluding one-off and other temporary measures, by 1.5 per cent of GDP in 2006, and at least $\frac{3}{4}$ per cent of GDP in 2007 and in 2008. Under Article 104(7) a Council Recommendation was also adopted on 7 October 2005 asking Portugal to take effective action regarding the measures needed to address the excessive deficit situation.⁹

Against this background, a word is in order regarding some limitations concerning the monitoring and collection of fiscal data. A specific commission led by the Banco de Portugal was created in 2002 to determine the value of the 2001 budget deficit. It was on the basis of that outcome, showing a much higher deficit than the one previously reported by the national authorities to Brussels that the first EDP for Portugal was triggered.

Yet again in 2005, another commission under the aegis of the Banco de Portugal concluded for the existence of still a higher number for the budget deficit in that year, more specifically of twice the 3 per cent limit. As already mentioned, Portugal then faced the second EDP in 2005. Therefore, it is somewhat worrying that in the past some limitations prevented the fiscal and statistical authorities of being able of accurately monitoring the outcomes of the several public finances related variables. Indeed, and even if this is not an easy task, one expects all steps of the budgetary process and the

⁸ Guichard and Leibfritz (2006) also survey the reasons for the non-successful fiscal adjustment in the period 2002-2004.

⁹ A detailed timeline regarding the excessive deficit procedures for Portugal is presented in Appendix 1.

ensuing implementation and monitoring of fiscal policy to be tackled in a timely fashion by the fiscal authorities.

The second EDP was still underway at the end of 2006, and among the several measures proposed by the authorities to control primary spending, one can mention as some of the more structurally oriented ones, for instance, the revision of the civil servants' pension schemes (see section 4), and the reform of the health care sector.¹⁰

Portugal's difficulties and experiences with excessive deficit situations are not an exception in the EU. As a matter of fact, in the last years other members of the EU also faced an EDP (in the euro area Portugal, Greece, France, Germany and Italy were undergoing an EDP at the end of 2006).¹¹ Table 1 provides the development of the relevant fiscal variables, budget deficit and general government debt, for each country in 1996 and in 2006.¹²

Table 1 – Budget balance and debt-to-GDP ratios

	Budget balance		Debt			Budget balance		Debt	
	1999	2006	1999	2006		1999	2006	1999	2006
Austria	-2.2	-1.3	66.5	62.1	Czech Republic	-3.6	-3.5	15.8	30.9
Belgium	-0.5	-0.2	113.6	89.4	Cyprus	-4.4	-1.9	59.7	64.8
Denmark	2.3	4.0	57.4	28.5	Estonia	-3.7	2.5	6.2	4.0
Finland	1.7	2.9	46.7	38.8	Hungary	-5.5	-10.1	60.0	67.6
France	-1.7	-2.7	58.3	64.7	Latvia	-5.3	-1.0	12.4	11.1
Germany	-1.5	-2.3	60.2	67.8	Lithuania	-2.9	-1.0	23.0	18.9
Greece	-3.4	-2.6	112.3	104.8	Malta	-7.7	-2.9	56.4	69.6
Ireland	2.5	1.2	48.1	25.8	Poland	-1.8	-2.2	39.3	42.4
Italy	-1.7	-4.7	113.7	107.2	Slovak Republic	-7.1	-3.4	47.4	33.0
Luxemburg	3.3	-1.5	5.6	7.4	Slovenia	-2.0	-1.6	24.6	28.4
Netherlands	0.6	0.0	60.5	50.5	EU-25		-2.0		62.5
Portugal	-2.7	-4.6	51.4	67.4	Bulgaria *	0.1 *	3.3	54.0 *	25.8
Spain	-1.1	1.5	61.6	39.7	Romania	0.7	-1.4	24.0	13.7
Sweden	2.5	2.8	62.2	46.7					
United Kingdom	1.1	-2.9	44.2	43.2					
Euro area	-1.3	-2.0	71.7	69.4					

Source: EC, autumn 2006 forecasts.

¹⁰ Actually, since 2002, some public hospitals have been transformed into public corporations, in an attempt to increase efficiency and decrease costs in the National Health Service, and the verdict is still out on the efficacy of these measures.

¹¹ By the end of 2006, other countries already faced an EDP: Czech Republic, Cyprus, Hungary, Malta, Poland, and Slovak Republic. Additionally, in 2004 both the UK and the Netherlands found themselves in excessive deficit, vis-à-vis the 2003 budget deficit outcome.

¹² For the status of the EDP on a country basis, one can see the main relevant information at the EC site: http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm.

From Table 1, one can see that according to the EC forecasts, two of the euro area countries had in 2006 a deficit above 3 per cent of GDP (Italy and Portugal), and seven countries still had a debt-to-GDP ratio higher than the 60 per cent threshold. Regarding the EU new Member States, three countries reported a deficit above 3 per cent (the Czech Republic, Hungary and the Slovak Republic), while three countries surpassed the debt ratio limit (Cyprus, Hungary and Malta).

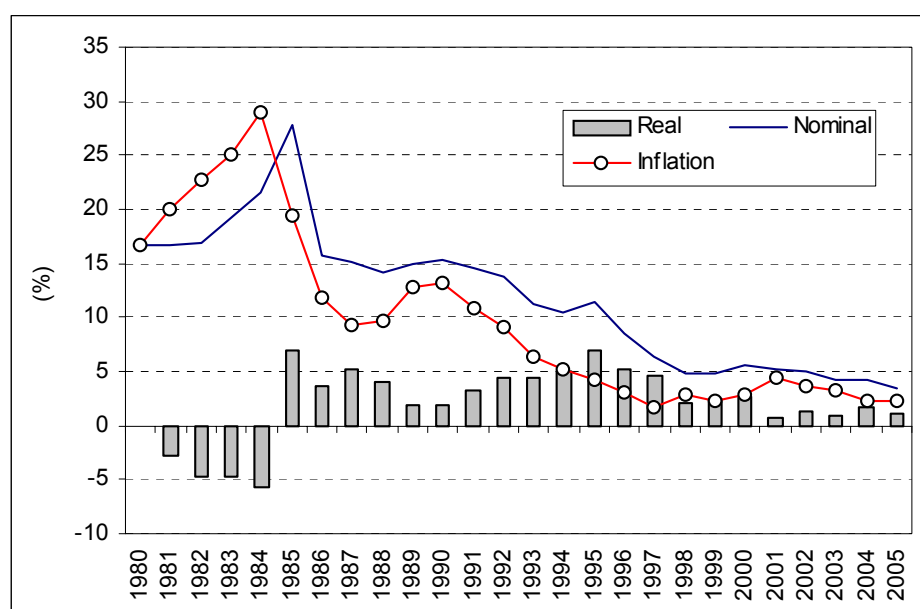
According to Afonso and Claeys (2006), the main reasons for the three initial breaches of the SGP in 2002 and 2003 seem to be expenditure rises in France and Portugal, while large revenue reductions unmatched by expenditure cuts in Germany pushed the deficit beyond 3 per cent of GDP. This evidence again seems to point, as already mentioned, to some difficulties related to expenditure control in the case of Portugal.

3.3. The capital markets view

After entering the EU in 1986 both inflation and interest rates in Portugal decreased steadily and converged towards the lower levels that were more common in other countries in Europe. This was an obvious benefit from entering the EU, with capital markets adjusting its expectations vis-à-vis Portugal, which also allowed for better and more stable sovereign debt ratings attributed to the country.

Undeniably, Portugal was one of the countries that most had to gain from the decrease in interest rates, given the quite high inflation and interest rate levels that it incurred in the past. Indeed, between 1985 and 1993, the long-term interest rate decreased around 1650 basis points (bp), opening an extremely important window of opportunity to engage in fiscal consolidations. It then further declined by some 700 bp from 1993 to 2003 (see Figure 7).

Figure 7 – Long-term government bond interest rates in Portugal



Source: European Commission.

Regarding recent developments in sovereign credit ratings in the euro area, in 2006 only the rating for Italy was reduced. On October 2006 Standard & Poor's (S&P) lowered its rating notation on Italian sovereign debt from AA- to A+ while Fitch decreased its own rating assessment from AA to AA-. The downgrade from Fitch moved Italian sovereign debt from the usually labelled “high quality” borrowing to the “strong payment capacity” category.

The sovereign credit ratings at the end of 2006 in the euro area are reported in Table 2. One can also notice that the minimum credit rating for collateral, accepted by the European Central Bank for its financial market activities, is at least A- from S&P or Fitch or at least A3 from Moody's.

Interestingly, the announcement of the rating downgrade for Italy in 2006 had a somewhat benign effect on its 10-year government bond yield. Moreover, the yields of the 10-year government bonds of Portugal have been steadily located, since the middle of 2005, inside a range between the yields of Greece and Italy in the upper bound, and the yields of Germany and France in the lower bound (see Figure 8). Additionally, the

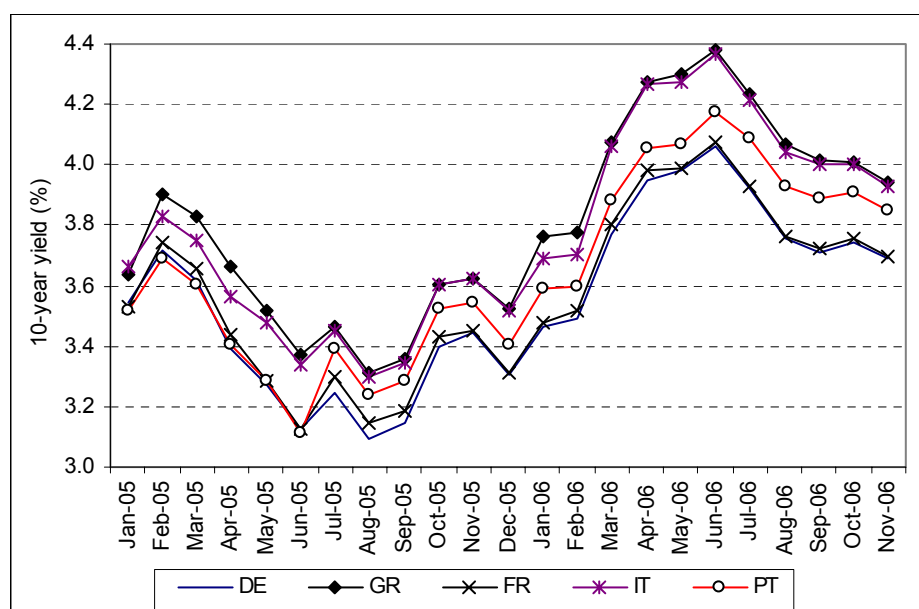
spreads for Portugal vis-à-vis Germany have remained almost stable during the last two years.

Table 2 – Sovereign credit ratings for euro area countries (December 2006)

Characterization of debt and issuer (source: Moody's)	Ratings					
	S&P	Countries	Moody's	Countries	Fitch	Countries
Highest quality	AAA	AT, DE, ES, FI, FR, IR, LU, NL	Aaa	AT, DE, ES, FI, FR, IR, LU, NL	AAA	AT, DE, ES, FI, FR, IR, LU, NL
High quality	AA+	BE	Aa1	BE	AA+	BE
	AA	SL	Aa2	IT, PT	AA	PT
	AA-	PT	Aa3	SL	AA-	IT, SL
Strong payment capacity	A +	IT	A1	GR	A+	
	A	GR	A2		A	GR
	A-		A3		A-	

Sources: S&P, Moody's, and Fitch.

Figure 8 – 10-year government bond yield (end-of-month)



Source: Reuters.

So far capital markets seem to have given the benefit of the doubt to Portugal in spite of less than reassuring past fiscal developments. Actually, empirical evidence suggests that the interest rate differentials do not react much to changes in the fundamentals, being the bond yields in the euro area bond market mostly driven by common factors. Naturally, this increases the relevance of sound fiscal policies in a monetary union in order to avoid

negative spillover effects as pointed out, for instance, by Detken, Gaspar and Winkler (2004).

On the other hand, and as mentioned by Afonso, Gomes and Rother (2007), fiscal performance does matter in determining sovereign credit ratings. Moreover, according to S&P and Fitch, the downgrade of Italian sovereign debt in 2006 was due to the fact that the 2007 Budget relied more on revenue measures to cut down the general government deficit, a strategy that did not address the expenditure side, notably current spending. Therefore, other EU countries with fiscal imbalances cannot really dismiss lightly this credit rating downgrade episode regarding Italy.

3.4. Stress test

In order to simulate and assess in a straightforward way possible future paths for public finances in Portugal, one can use the arithmetic of the government budget constraint,

$$b_t - b_{t-1} = g_t - \rho_t + (i_t - n_t)b_{t-1} \quad (1)$$

where b is the debt-to-GDP ratio, g is the primary spending-to-GDP ratio, ρ is the revenue-to-GDP ratio, and i and n are respectively the nominal long-term interest rate and the nominal GDP growth rate.¹³ The simulation for the debt ratio at time t may then be computed from

$$b_t = b_{t-1} + g_t - \rho_t + (i_t - n_t)b_{t-1}, \quad (2)$$

while the budget balance, d , can be calculated from

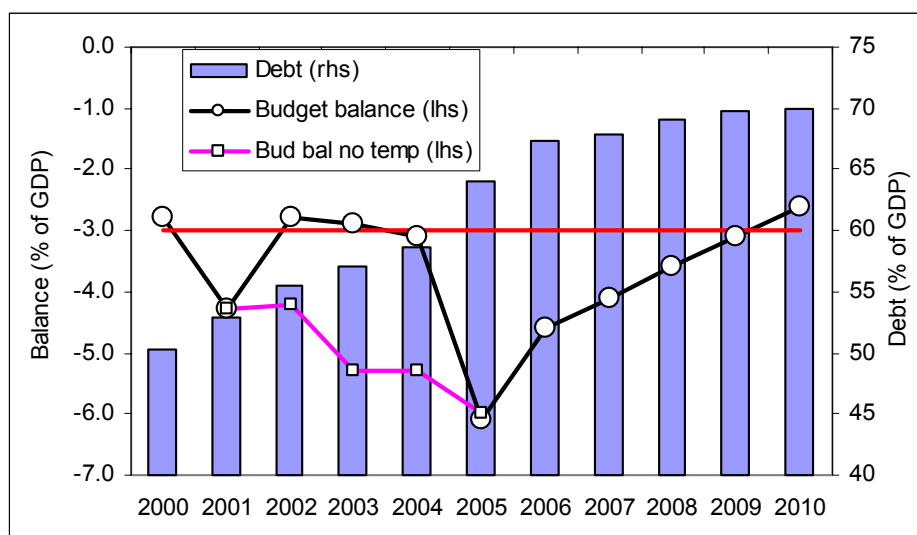
$$d_t = \rho_t - g_t - i_t b_{t-1}. \quad (3)$$

¹³ See, for instance, Afonso (2005), for more details on the budget constraint arithmetic.

The main assumptions used in the calculations, throughout a period of four years ahead are as follows: nominal GDP growth rate, 3.5 per cent; nominal long-term interest rate, 4.5 per cent; expenditure ratio development, -0.5 pp of GDP annually; revenue ratio development, 0.0 pp annually.¹⁴

Making a simple stress test using (2) and (3), for the period 2007-2010, shows the difficulties underlining the development in Portuguese public finances, and Figure 9 presents the results of such exercise. The main conclusion is that given past spending and revenue dynamics, and sensible and cautious assumptions for future spending and revenues, it may take four to five years for Portugal to overcome a situation of excessive deficit, once the budget deficit is as high as twice the three per cent threshold, and government debt is approximately 67 per cent of GDP.

Figure 9 – Pubic finances stress test for Portugal



Sources: European Commission, autumn 2006 Forecasts and Portuguese Stability Programme 2006-2010 (December 2006), and author's calculations. Note: the line with the square mark for the budget balance excludes one-off measures amounting to 1.4, 2.5, and 2.3 per cent of GDP respectively in 2002, 2003, and 2004.

Portugal's difficulties are compounded by the lack of a convincing cyclical recovery. According to the European Commission, the output gap in Portugal has been negative,

¹⁴ Regarding the development of the public spending ratio, an assumption of -0.5 pp annually for four years could be considered somewhat optimistic since the data show an increase of +0.5 pp annually in the four-year period ending in 2006.

averaging -1.0 per cent in the 2002-2006 period, which is twice as much as the one observed in the euro area. Finally, the rate of capacity utilization has also been historically low in recent years.

3.5. Fiscal consolidations

Regarding the past experiences in terms of fiscal consolidations, Table 3 identifies the fiscal episodes in the EU15 countries, based on the change in the cyclically adjusted primary budget balance. For this purpose, Afonso (2006) determined the periods when the change in the primary cyclically adjusted budget balance is at least 2 pp of GDP in one year or at least 1.5 pp points on average in the last two years. For the case of Portugal, Table 3 reports two episodes of fiscal contraction and three episodes of fiscal expansion between 1970 and 2005: 1982-83, 1986, and 1992.

Table 3 – Fiscal episodes (1970-2005)

	Expansions	Contractions		Expansions	Contractions
AU	76	84, 97, 01	IT		77, 83, 91-93
BE		82-83, 85, 95	LU	86-87, 02-04	83-85, 01
DK	76, 82, 94	83-86, 95-96	NL		91, 93, 95-96
FI	78-79, 87	76-77, 95-96, 00-01	PT	80-81, 05	82-83, 86, 92
FR		95-96	SP		95-96
GE	75, 90-91	82-83	SW	74, 79, 91-93, 01-02	76, 83-84, 87, 95-97
GR	75, 81, 85, 88-89, 01-02, 04	82-83, 86-87, 91-92, 94-97, 05	UK	72-73, 92-93, 02-03	81, 95-98
IR	74-75, 78-79, 95, 99, 01-02	76-77, 83-84, 88-89, 04			

Source: adapted from Afonso (2006), following the measure used by Alesina and Ardagna (1998).

Recalling Figure 4, it is possible to see that the abovementioned fiscal consolidation episodes were, on the one hand short-termed, and on the other hand mostly unsuccessful.

During the 1982-83 consolidation both expenditures and revenues increased, as a share of GDP, while the debt-to-GDP ratio kept on increasing at the same time.¹⁵

Regarding the 1986 consolidation (the year of Portugal's entry in the EU), one observes in that period a certain stabilization of revenues as a share of GDP, a decrease in the expenditure-to-GDP ratio, and also a decrease in the debt ratio in the following three years. Additionally, the primary balance was also in surplus for the first time in thirteen years.¹⁶

Finally, the 1992 episode was very short-termed, taking place in a difficult environment, following revenue and expenditure increases with the debt ratio rising immediately afterwards.¹⁷ Moreover, the 1993 economic downturn in Europe did not play in favour of prolonging the consolidation, with the primary spending-to-GDP ratio increasing more significantly in that year. Indeed, a known feature of fiscal policies in Portugal in the past has been the pro-cyclical behaviour of primary spending, which contributed to prevent the implementation of successful fiscal consolidations (see, for instance, Pina, 2004). Such pro-cyclical behaviour would again be present in 2001, with the budget deficit going once more above the 3 per cent limit.

According to the existent literature, one would be more inclined to attribute a higher degree of success to a fiscal consolidation if it is more based on the reduction of primary current expenditure than on the increase on revenues or on the reduction of capital spending. For instance, Alesina and Perotti (1997) define two types of fiscal adjustment: Type 1 adjustment, when the budget deficit is reduced through cuts in social expenditures (unemployment subsidies, minimum income subsidies) and cuts in public sector wages; and Type 2 adjustment, when the budget deficit is reduced with the increase of taxes on

¹⁵ It is also worthwhile mentioning that the Portuguese Escudo effective exchange rate faced a devaluation of 17 and 23 per cent respectively in 1982 and 1983, while Portugal undertook an IMF stabilisation programme.

¹⁶ In that year also occurred the effective introduction of VAT, and Portugal started receiving European funds.

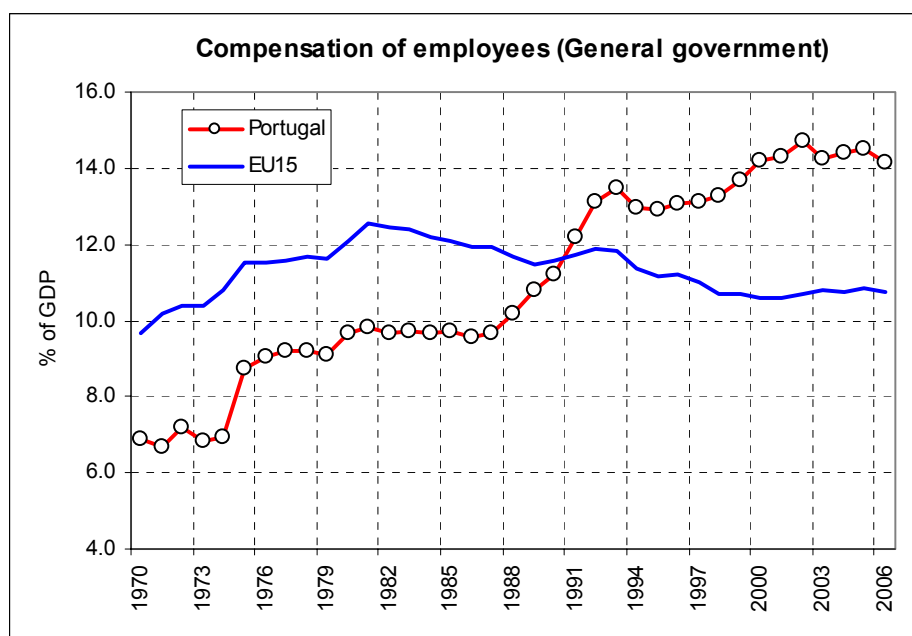
¹⁷ Additionally, in 1992 and in 1993 privatisation revenues amounting respectively to 1.5 and 0.4 per cent of GDP were used for debt redemption. Coincidentally Portugal entered the ERM in April 1992, precisely the year were several currencies in the ERM system undergone speculative attacks, forcing both the Italian Lira and the British Pound out of the system after September 2002.

labour income and with cuts in public investment expenditures. Against this background, one could tentatively label the episodes of fiscal consolidation of 1982-83 and 1992 more likely as Type 2 adjustments, while the 1986 episode may have had more features of a Type 1 adjustment.

4. Compensation of employees and competitiveness

Compensation of employees in Portugal diverged vis-à-vis the EU15 average after the adhesion to the EU in 1986, a development that may have impinged adversely on the country's competitiveness. Indeed, compensation of employees as a share of GDP increased roughly 1.0 percentage point of GDP for the EU15 countries, between 1970 and 2006 while it increased quite more substantially in Portugal (see Figure 10).

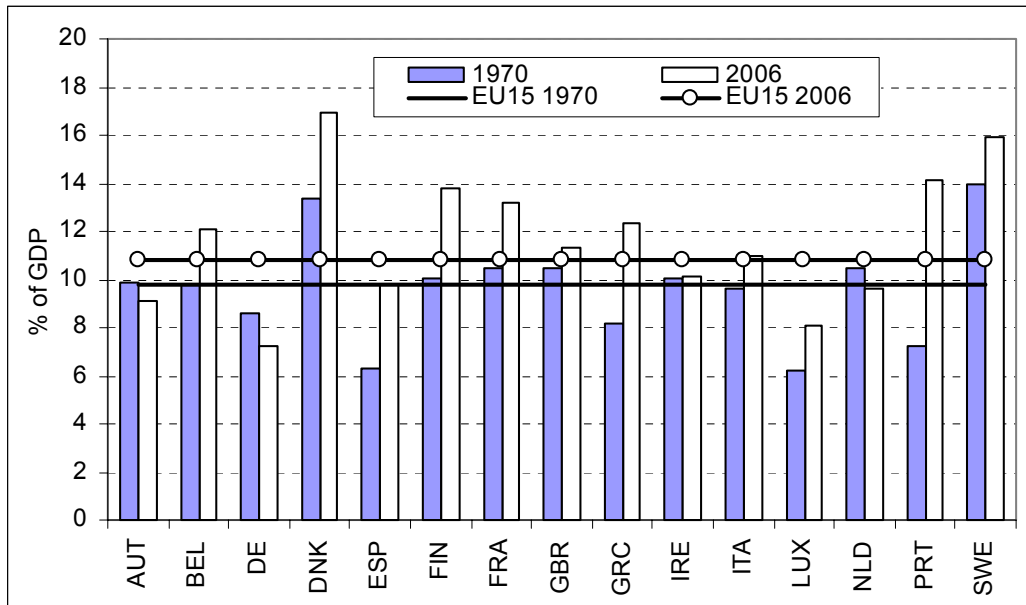
Figure 10 - Compensation of employees (% of GDP), Portugal and EU15



To better place the Portuguese case in the broader picture of the EU15, it is important to mention the existence of large differences both among countries and through time in terms of this public spending category. For instance, one can mention that compensation of employees as a share of GDP in 1980 ranged from 9.4 per cent in Greece and Spain to 18.0 and 20.2 per cent in Denmark and Sweden. On the other hand, in 2006 the lowest

values for those ratios were 7.2, 8.1 and 9.6 per cent respectively in Germany, Luxembourg and in the Netherlands, while the highest reported values were 17.0 per cent in Denmark, 15.9 per cent in Sweden and 14.2 per cent in Portugal (see Figure 11).

Figure 11 – Compensation of employees (% of GDP), EU15



Source: European Commission.

In spite of the moderate general increase in the share of compensation of employees in GDP, between 1970 and 2006 in the EU15, the compensation of employees-to-GDP ratio did increase more significantly in five countries: Portugal, Greece, Finland, Denmark, and Spain. The biggest increases during that period occurred in Portugal and Greece, with respectively changes of 6.9 and 4.1 percentage points. On the other hand, compensation of employees as a share of GDP either decreased between 1970 and 2006 in three countries, Germany, Netherlands and Austria, or remained broadly stable in Ireland.

A different way of looking at the weight of the compensation of employees, it to notice that in the EU15 such public spending item accounted for 27.6 per cent of the general government's total expenditures in 1970, decreasing to 22.8 per cent in 2006 (a decline of 4.9 pp). Once more it is possible to identify significant differences among the EU15 countries. In 2006, the weight of public sector compensation of employees ranged from 15.7, 18.4 and 18.8 per cent of total expenditure in Germany, Luxembourg and Austria to

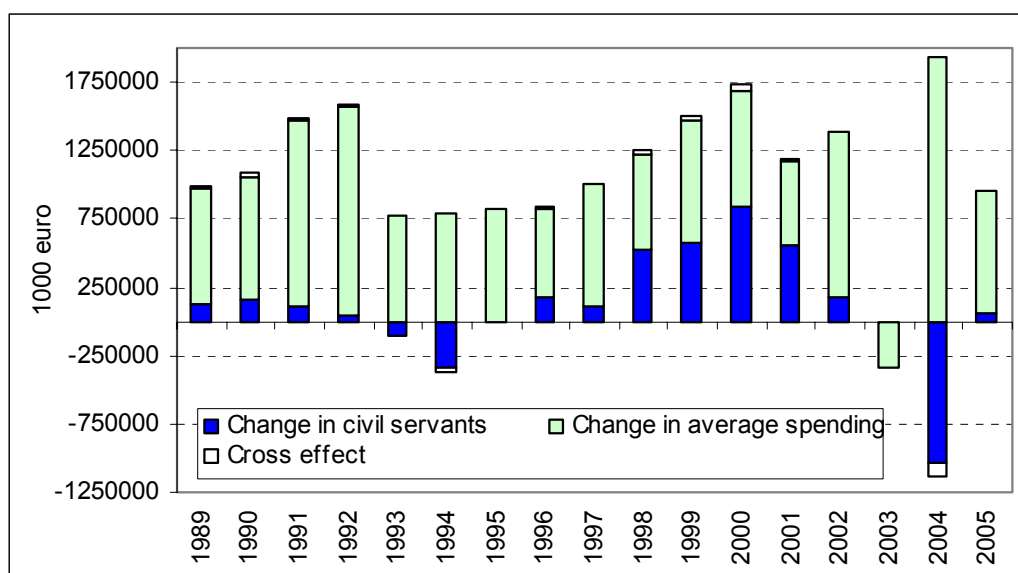
33.4 and 29.5 per cent respectively in Denmark and in Portugal (see Appendix 2 for country details).

In order to assess the contributions to the change in the compensation of employees, it is possible to decompose the variation of that spending category as follows:

$$\Delta W = \underbrace{\Delta N \times w}_{\text{Effect via change in civil servants}} + \underbrace{\Delta w \times N}_{\text{Effect via change in average spending}} + \underbrace{\Delta N \times \Delta w}_{\text{Cross effect (residual)}} \quad (4)$$

where we have: W – compensation of employees (general government); N – number of civil servants (as recorded in the CGA); and w – average spending per employee (W/N).¹⁸ The results for Portugal for the period 1989-2005, using the decomposition equation (4), are presented in Figure 12.

Figure 12 – Contributions to changes in compensation of employees
(General government)



Source: CGA, EC, and author's calculations.

¹⁸ CGA manages the Portuguese civil servants (appointed until 2005-12-31) pension's scheme (retirement, survivor and other minor special pensions). This contributory pay-as-you-go special scheme covers also teachers from private schools and workers of some public (or State owned though private) companies appointed until 2005-12-31. See Appendix 2 for the data used in equation (4).

Between 1989 and 1992, a period of strong increase in the share of the compensation of public employees in GDP, the increase in the average spending per civil servant was essentially the main driving force. On the other hand, it is possible to observe a period of four years, 1998-2001, where the increase in the number of civil servants contributed more significantly to the overall increase in the compensation of employees-to-GDP ratio. Still one also notices the negative contribution from the change in civil servants observed in 2004.

In this context, it is worthwhile mentioning the recent reform of the public sector employees' pension system, which apart from being intended to contribute to curb primary spending in the general government, may constitute in the medium-term an additional incentive for civil servants to move from the public to the private sector.¹⁹

Another relevant dimension, related to Portugal's external competitiveness, can be assessed by comparing both the compensation of general government employees and labour costs with the realities' of Portugal's traditionally main trading partners. This comparison is done in Figures 13a-c for Spain, France, Germany and the UK.

In terms of the share in GDP of the compensation of general government employees, such ratio has been in Portugal above the observed in Germany, Spain, France, and the UK for most of the last ten years (see Figure 13a). Regarding the compensation of employees for the total economy, the picture is opposite, with the respective ratio to GDP being lower in Portugal. Nevertheless, such ratio also increased after 1998, and actually surpassed the corresponding ratio for Spain in 2005 (see Figure 13b). Finally, Figure 13c reports real unit labour costs developments showing an upward trend for the case of Portugal after 2000, in opposition to the mostly downward trend that occurred in Portugal's four main trading partners.

¹⁹ Among the measures implemented under the revised civil servants' pension scheme we can mention the stepwise rise (six month every year) in the retirement age from 60 to 65 years, during the period 2006-2015, and the increase, in the same stepwise fashion, in the number of working years to receive the full pension, from 36 to 40 years, during the period 2006-2013.

Figure 13a

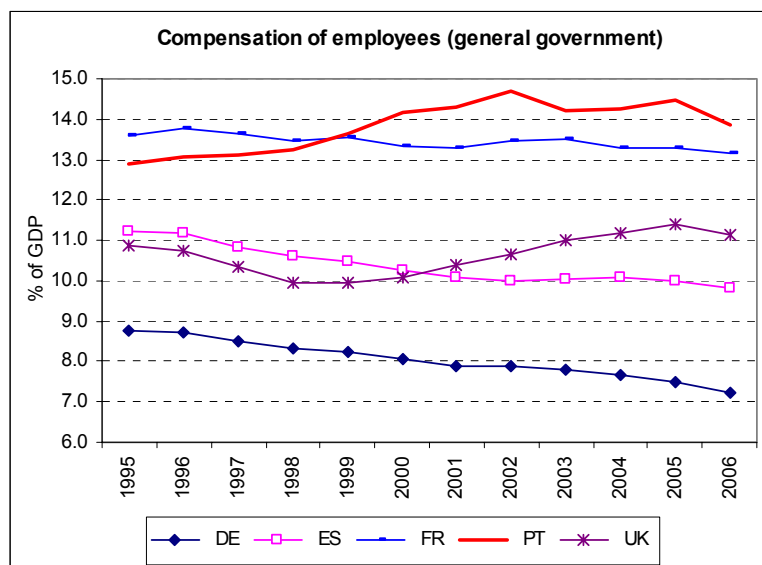


Figure 13b

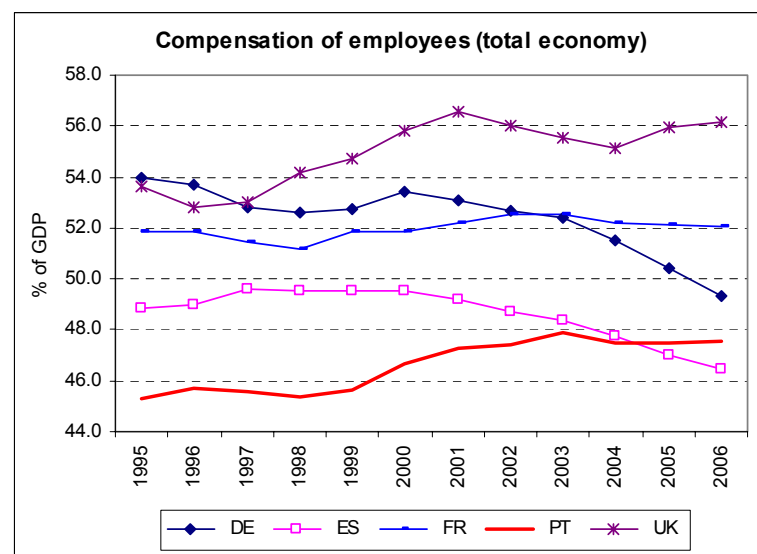
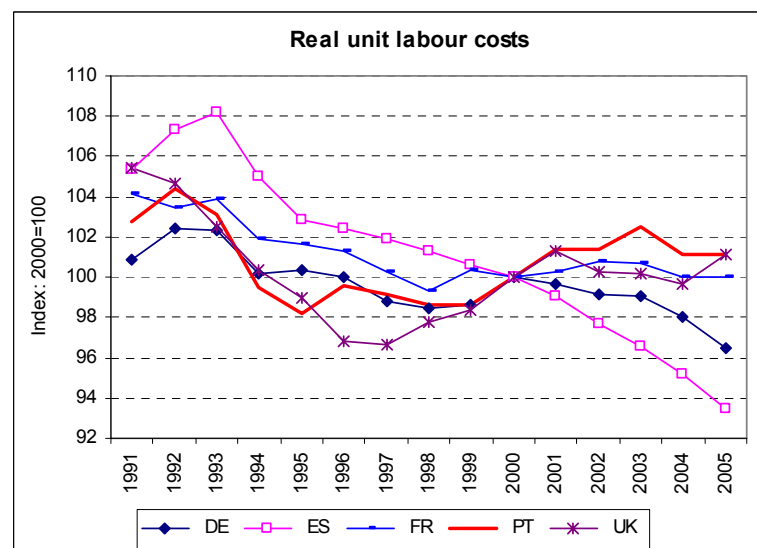


Figure 13c



5. Conclusion

In the past, public spending control has been a problem in Portugal, with significant increases in primary spending. In the period of twenty-one years after Portugal's adhesion to the EU in 1986, only in six years was the budget deficit below the 3 per cent of GDP, averaging around 4 per cent in the entire period. Certainly, the fiscal consolidations that occurred in the 1980s and 1990s have been short-termed and mostly not successful.

Quite telling of a lack of a strong commitment to sustainable fiscal consolidation efforts in Portugal is the fact that even though the debt ratio declined during some periods, notably due to strong growth, and dropping interest rates, the total expenditure ratio did not decline simultaneously. Indeed, between 1985 and 1993, the long-term interest rate decreased around 1650 bp and it then further declined by some 700 bp from 1993 to 2003. So far, capital markets have given the benefit of the doubt to Portugal, but this may change in the future in the absence of good fiscal performance.

The compensation of general government employees, as a share of GDP, diverged vis-à-vis the EU15 average after 1987-88, while overall, unit labour costs exhibited a higher growth than in the case of Portugal's main trading partners. The rise in the share of the compensation of public employees in GDP was related to the increase in average spending per civil servant between 1989 and 1992, and notably also to the increase in the number of civil servants in the period 1998-2001.

Some of the experiences of Portugal, both the preparation to the euro and the euro experience itself, may provide useful insights to the EU new Member States that will adopt the single currency in the future. Indeed, one must be aware of the implications and requisites of the need of sound fiscal policies coupled with a single monetary policy, in order to adjust procedures and take full advantage of such policy environment.

Finally, one can briefly sketch some desirable features that should surround the implementation of fiscal policy in Portugal: fiscal policy should not be pro-cyclical; consolidations need to be pursued in order to attain a sound fiscal position that can deal

with unforeseen shocks and prepare for the future fiscal costs of ageing populations; structural measures rather than temporary ones should be favoured; the fiscal authorities should monitor, collect, and provide comprehensive fiscal data in a timely fashion for all sub-sectors of the general government; a periodical assessment of public finances objectives and implementation, from an autonomous perspective, would also be welcomed to help steer fiscal policy decisions towards a sustainable path.

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Appendix 1

EDP timeline for Portugal

Date	Report/Recommendation/Decision
24 Sep 2002	Commission report [104(3)]
16 Oct 2002	Commission opinion [104(5)] and recommendation for a Council decision [104(6)] and recommendation [104(7)]
5 Nov 2002	Council decision [104(6)] Council recommendation [104(7)]
28 Apr 2004	Commission recommendation for a Council decision [104(12)] abrogating the Decision on the existence of an excessive deficit
11 May 2004	Council decision [104(12)] to abrogate the Decision on the existence of an excessive deficit
22 Jun 2005	Commission report [104(3)]
20 Jul 2005	Commission opinion [104(5)] and recommendation for a Council decision [104(6)] and recommendation [104(7)]
7 Oct 2005	Council decision [104(6)] Council recommendation [104(7)]
21 Jun 2006	Commission communication to the Council on the action taken in response to the Council recommendations under the excessive deficit procedure

Source: EC, last update 21 June 2006.

Appendix 2

Table A1 – Compensation of employees (General Government, % of GDP)

	Total spending (1)			Compensation of employees (2)			(1)/(2)		
	1970	2006	change (pp)	1970	2006	change (pp)	1970	2006	change (pp)
AUT	37.1	48.6	11.4	9.9	9.1	-0.7	26.6	18.8	-7.8
BEL	38.9	49.6	10.7	9.8	12.1	2.3	25.1	24.4	-0.7
DEU	37.7	46.1	8.4	8.6	7.2	-1.4	22.8	15.7	-7.1
DNK	40.1	50.8	10.7	13.4	17.0	3.6	33.4	33.4	0.0
ESP	20.3	38.3	18.1	6.3	9.8	3.5	31.0	25.6	-5.4
FIN	29.6	49.9	20.3	10.1	13.8	3.7	33.9	27.6	-6.3
FRA	36.7	54.0	17.4	10.5	13.2	2.7	28.5	24.4	-4.1
GBR	36.3	45.2	8.9	10.5	11.3	0.8	28.9	25.0	-3.8
GRC	24.2	44.9	20.7	8.2	12.3	4.1	33.7	27.4	-6.3
IRE	33.8	34.9	1.1	10.0	10.1	0.1	29.6	29.0	-0.6
ITA	32.1	48.1	16.0	9.6	11.0	1.4	30.0	22.9	-7.1
LUX	25.3	44.0	18.7	6.2	8.1	1.9	24.6	18.4	-6.2
NLD	38.4	47.7	9.3	10.5	9.6	-0.8	27.2	20.2	-7.0
PRT	18.7	48.0	29.3	7.2	14.2	6.9	38.7	29.5	-9.2
SWE	41.8	55.9	14.1	14.0	15.9	1.9	33.5	28.5	-5.0
E15	35.4	47.3	11.9	9.8	10.8	1.0	27.6	22.8	-4.9

Source: European Commission. Note: numbers may not add up due to rounding.

Table A2 – Civil servants and compensation of employees

	Civil servants, CGA (N)	Change in civil servants (%)	Change in Compensation of employees, GG (W)		W/N
	units		€1,000	(%)	
1988	615515	-	3937010	-	6.396
1989	634001	3.0	4931670	25.3	7.779
1990	653842	3.1	6011700	21.9	9.194
1991	665236	1.7	7504690	24.8	11.281
1992	668715	0.5	9087470	21.1	13.589
1993	661347	-1.1	9759280	7.4	14.757
1994	638327	-3.5	10184340	4.4	15.955
1995	637749	-0.1	10990150	7.9	17.233
1996	647893	1.6	11828910	7.6	18.258
1997	654228	1.0	12841880	8.6	19.629
1998	681169	4.1	14096300	9.8	20.694
1999	709167	4.1	15599830	10.7	21.997
2000	747449	5.4	17328770	11.1	23.184
2001	771285	3.2	18515950	6.9	24.007
2002	778782	1.0	19906640	7.5	25.561
2003	778357	-0.1	19567660	-1.7	25.140
2004	737355	-5.3	20376270	4.1	27.634
2005	739664	0.3	21327560	4.7	28.834

Source: CGA, European Commission. CGA manages the Portuguese civil servants (appointed until 2005-12-31) pension's scheme (retirement, survivor and other minor special pensions). This contributory pay-as-you-go special scheme covers also teachers from private schools and workers of some public (or State owned though private) companies appointed until 2005-12-31.